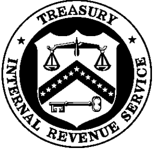

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

October 11, 2001

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL (LMSB)

ATTN: CC:LM:NR:

FROM: Lewis K Brickates, Senior Technician Reviewer
CC:CORP:4

SUBJECT:

/Basis Shift (302/318 Loss Importation)

This Field Service Advice responds to your memorandum dated June 8, 2001. In accordance with section 6110(k)(3) of the Internal Revenue Code, this Field Service Advice should not be cited as precedent.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

LEGEND

TP =

PRS =

FC =

FP =

FB =

Promoter =

Preparer =

Administrator =

Program =

B =

C =

X =

Y =

Z =

State A =

Country A =

Country B =

BC =

Year 1 =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

Date 8 =

Date 9 =

Date 10 =

Date 11 =

Date 12 =

Date 13 =

Date 14 =

Date 15 =

Date 16 =

Date 17 =

Date 18 =

Date 19 =

Date 20 =

Date 21 =

Date 22 =

Date 23 =

a =

b =

c =

d =

e =

f =

g =

h =

i =

j =

k =

l =

m =

n =

o =

p =

q =

r =

s =

t =

u =

v =

w =

x =

y =

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aa =

bb =

cc =

dd =

ee =

ff =

gg =

hh =

ii =

jj =

kk =

ll =

mm =

nn =

oo =

pp =

qq =

rr =

ss =

tt =

uu =

ISSUES

1. Whether FC, in substance, owned the shares of FB stock that were redeemed.

2. If FC is treated as having properly acquired the shares of FB stock that were redeemed, whether FB's redemption of its stock held by FC is an exchange or a distribution to which section 301 applies.

3. If FB's redemption of its stock held by FC is deemed to be a distribution to which section 301 applies, whether TP's adjustment to his basis in FB stock was a "proper adjustment" within § 1.302-2(c) of the Income Tax Regulations.

4. If TP's adjustment to his basis in FB stock was a "proper adjustment," whether TP's stock loss was not a bona fide loss with the result that the purported stock loss is disallowed under section 165.

5. If TP's adjustment to his basis in FB stock was a "proper adjustment," whether TP acquired control of FC with a principal purpose of avoiding or evading Federal income tax with the result that the purported stock loss is disallowed under section 269.

6. Whether section 482 applies to reallocate any FB stock basis or loss claimed attributable to FC's basis in the FB stock to FC.

7. A. Whether the stock loss may be disallowed because the transaction as a whole lacks economic substance and business purpose apart from tax savings.

   B. Whether the sham entity doctrine should apply to recharacterize the transaction by disregarding the existence of FC as an entity separate from its owner.

<u>SUMMARY OF CONCLUSIONS</u>

1. FC did not, in substance, own the shares of FB stock that were redeemed.

2. Even if FC is treated as having properly acquired the shares of FB stock that were redeemed, the redemption should be treated as a payment in exchange for the stock, not as a dividend distribution.

3. Even if the redemption was treated as the distribution of a dividend, the addition of FC's basis in its FB stock to the basis of the FB stock held by TP is not a "proper adjustment" as contemplated under Treas. Reg. § 1.302-2(c).

4. Even if TP's adjustment to his basis in FB stock was a "proper adjustment," TP's stock loss was not a bona fide loss with the result that the purported stock loss is disallowed under section 165.

5. Even if TP's adjustment to his basis in FB stock was a "proper adjustment," TP acquired control of FC with a principal purpose of avoiding or evading Federal income tax with the result that the purported stock loss is disallowed under section 269.

6. Any FB stock basis or loss claimed that is attributable to FC's basis in the FB stock must be reallocated to FC under section 482.

7. A. The stock loss may be disallowed because the transaction as a whole lacks economic substance and business purpose apart from tax savings.

   B. The sham entity doctrine should apply to recharacterize the transaction because FC should be disregarded as an entity separate from its owner.

FACTS

In Year 1, TP, an individual subject to U.S. tax, pursuant to an offer from Y agreed to tender his stock in X to Y and would realize gain of approximately $a from his sale of X stock. To offset these gains, TP's accounting firm and tax return preparer, Preparer, introduced TP (through PRS, described below) to Promoter, an independent investment advisor registered under the 1940 Investors Act. Preparer issued a formal engagement letter dated Date 7 ("Engagement Letter") to TP and PRS describing the transaction as a Program and the various parties participation in the Program.

On Date 1, TP formed Z, a subchapter S corporation, and became its president. TP and his wife each owned half of the outstanding stock of Z.

On Date 1, TP also formed PRS, a limited partnership. TP was the only limited partner of PRS with a b-percent limited partnership interest. Z was the c-percent general partner of PRS.[1]

Also on Date 1, TP wrote a letter to the depository for the Y offer, allegedly transferring his X stock to PRS. The proceeds of the sale were wired to a bank account for PRS on Date 2.

B and C formed FC as a corporation organized under the laws of Country A on Date 3 (date when the Memorandum of Association of FC was registered and filed with the Registrar of Companies in Country A). At the present time, it is unclear whether TP or PRS participated in FC's organization. FC had authorized a total of d shares at $c par value each. B and C each initially held c shares in FC. On Date 4, B and C transferred their shares to FP. FP also acquired additional shares in FC for a total of e shares. To acquire these shares, FC loaned FP $f in exchange for an interest-free, demand note from FP due and payable no later than

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[1] Because all items of income, gain, loss and deduction from PRS flow through to TP and his wife, our reference to TP may also include PRS.

Date 5. At the present time, it is unclear where FP is domiciled and who are its shareholders.

Also on Date 4, PRS entered into a warrant agreement with FC to purchase g shares of FC stock (representing more than 50 percent of the total outstanding shares of stock). The warrant agreement required an up-front payment of $h and the warrant price to convert the warrants into FC stock was $i. Thus, the total cost for PRS to purchase the FC warrants and to convert the FC warrants into FC stock was $j of which k percent was required to be paid up-front pursuant to the terms of the warrant agreement. The warrant agreement further provided that a warrant could be exercised upon l days written notice to FC by PRS, but no later than Date 6. If all of the warrants were exercised, PRS would own b percent of the outstanding shares of FC, with the remaining c percent owned by FP. However, if FP's voting interest fell below m percent upon PRS's exercise of the warrants, FP was entitled to put its FC shares back to FC for a net payment of $d (i.e., $n less the $f interest-free, demand note). Finally, if the warrants were not exercised, PRS was entitled to put the warrants back to FC for the net asset value (defined as the value of the FC assets less the value of the FC liabilities and an additional $d).

As noted above, the terms of the warrant agreement required an up-front payment of $h for the warrants. PRS wired $h to Administrator, the administrator under the warrant agreement. PRS also wired $p to Promoter.[2] In calculating PRS's short-term capital loss on the subsequent disposition of PRS's FC warrants, we note that PRS included the entire $o in its basis. Therefore, we presume that the entire $o was treated as payment to FC for the acquisition of the FC warrants and as an advance on the conversion of the FC warrants into ordinary shares.

On Date 4, TP and Promoter entered into an investment advisory agreement and Exhibit A to this agreement states that TP's investment objective was to seek capital appreciation by purchasing and owning long $q equivalent of common stock of FB, a publicly-held bank organized in Country B. Exhibit B to this agreement

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[2] The additional $p payment may be viewed as either a contribution to FC's capital and/or as payment of the strike price necessary to convert the FC warrants into FC stock. For this reason, we recommend that the field independently verify whether PRS was under a legal obligation to pay this amount and, if so, the nature of such legal obligation. For example, In the Engagement Letter from Preparer, Preparer advised TP and PRS that FC may pay fees to FB, Promoter, legal counsel and Preparer "in amounts which may be more, less, or equal to your warrant price in this entity in consideration of the services rendered in structuring, facilitating and executing the Program. Should [TP] or [PRS] incur any additional fees in connection with the Program for advisors, consultants, legal council [sic] or any other parties, those costs will be the responsibility of [TP] and [PRS]."

provides that TP is required to pay Promoter a flat fee of $r upon the sale of the $q equivalent of FB common stock contemplated in Exhibit A.

On Date 7, FC and Promoter entered into an investment advisory agreement with Administrator also serving as the administrator for this agreement. Exhibit A to this agreement states that FC's investment objective was to seek capital appreciation through an investment strategy involving the bearer shares and related derivative securities of FB. The initial account value specified in this agreement was $h and the notional account value was $s. Thus, the initial account value of this investment advisory agreement was identical to PRS's up-front payment required under the warrant agreement and the notional account value was roughly the same as TP's gain realized on the sale of the X stock.

On Date 8, TP purchased from FB t bearer shares of FB stock for BCu per share. On Date 9, TP apparently transferred these FB bearer shares to PRS.

Also, on Date 8, FC entered into an agreement with FB to purchase shares of FB. FC made a e-percent leveraged acquisition of v bearer shares of FB stock at a purchase price of BCw per share with FB receiving an additional BCx per share as prepaid interest. Under the terms of the agreement, FB retained possession of the bearer shares and payment was delayed until the settlement date on Date 10. As part of this agreement, FC paid FB a net deposit amount equal to BCy which, according to the deposit agreement attached thereto, was partially offset by the difference between the premiums payable under the put option and the call option. Specifically, FC sold to FB a call on v FB shares with an initial strike price of BCz per share and a strike reset price of BCaa per share, if the price of the shares fell below BCz per share during the holding period. The premium for the call was BCbb per option. The call also had an integrated forward feature: FB was required to pay BCcc to FC for each day the share price exceeded the following levels:

Date 11 to Date 12 (inclusive): BCdd
Date 13 to Date 14 (inclusive): BCee
Date 15 to Date 16 (inclusive): BCff
Date 17 to Date 10 (inclusive): BCgg

If at any time the share price fell below the reset strike price, FB would pay to FC an amount equal to BCcc multiplied by the number of days the share price exceeded the above levels prior to the share price falling below the strike reset price.

Finally, as part of the agreement, FC purchased from FB, on the same date, a put on v FB shares with a strike price of BCaa. The premium for the put was BChh per option.

The initial strike price of the call was approximately ii percent of the price of the shares. Both the strike reset price of the call and the put strike price were jj percent of the price of the shares. The options were European-style options and were exercisable on Date 10.

On Date 10, FB exercised its call option on v of its bearer shares from FC for BCaa per share. Simultaneously, TP purchased options to acquire v bearer shares of FB stock for BCkk per share from FB. Although TP's purchase had a trade date of Date 10, the purchase was not effective until Date 18. TP contributed these options to PRS on Date 9 as a contribution to capital.

TP treated FB's exercise of the call option as a redemption. Since PRS's ownership of the FC stock warrant purportedly represented a b-percent ownership interest in FC, TP treated FC as owning all of the stock that PRS owned, directly or indirectly, pursuant to section 318(a)(5)(A). Thus, under section 302(d), TP treated the redemption of FB stock held by FC as a dividend. Pursuant to Treas. Reg. § 1.302-2(c), TP then allocated FC's basis in its FB stock to PRS's t shares of FB stock and to its option to acquire v shares of FB stock based on their relative fair market values as of Date 10.

On Date 19, PRS sold ll shares of its FB stock at BCmm per share. Despite the fact that PRS sold the ll shares of FB stock at a greater price than TP had paid for the shares, PRS reported a short-term capital loss on the sale. PRS sold the remaining nn shares of FB stock on Date 20, at a reported loss.

On Date 21 and Date 22, PRS sold the FB options contributed earlier by TP at BCoo and BCpp per share, respectively. Despite the fact that PRS sold these options at a price greater than TP had paid for them, PRS reported a short-term capital loss from the sale of the options.

On Date 23, PRS put the FC warrants to FC for $qq and reported a short-term capital loss of $rr. Presumably, this loss amount represents the difference between the original $o wire transfer to Administrator under the FC warrant agreement less the $qq that PRS received when it put the FC warrants back to FC. Thus, TP appears to have taken a return position that it paid the entire $o for the FC warrants.

TP used the total tax losses to offset the approximate $a gain from TP's sale of stock in X.

LAW AND ANALYSIS

The Service may utilize several legal arguments to challenge the purported tax benefits claimed by the parties to the various steps of the transaction described above (the "Transaction").

ISSUE 1: Whether FC, in substance, acquired the shares of FB stock that were redeemed.

In general, federal income tax consequences are governed by the substance of a transaction. See Gregory v. Helvering, 293 U.S. at 470. A sale has not occurred if the benefits and burdens of ownership have not passed to the purported purchaser. See Highland Farms, Inc. v. Commissioner, 106 T.C. 237, 253 (1996); Grodt & McKay Realty, Inc. v. Commissioner, 77 T.C. 1221, 1237 (1981).

In determining whether the benefits and burdens of ownership have shifted, courts have considered various factors. These factors include: (1) whether the sale price was fixed; (2) whether a significant amount of the agreed price has been paid; (3) the descriptive terms used in the agreement; (4) whether an effective date has been agreed upon fixing a specific time for recognition of the rights and obligations of the party; (5) whether the purchaser bears the risk of loss and opportunity for gain; (6) whether legal title has passed; (7) the intention of the parties; and (8) the probability that the transaction would be consummated. See Grodt & McKay Realty, Inc, 77 T.C. at 1237-38; Clodfelter v. Commissioner, 48 T.C. 694, 700-01 (1967), aff'd. 426 F.2d 1391 (9th Cir. 1970); and Maher v. Commissioner, 55 T.C. 441, 451-52 (1970), aff'd in part and remanded in part 469 F.2d 225 (8th Cir. 1972), nonacq. 1977-2 C.B. 2. Not all the factors listed above must be present for the transaction to be treated as a sale. Maher, 55 T.C. at 452.

An analysis of a few of the factors listed above initially suggest that ownership of the FB shares has been transferred to FC. For instance, since the transaction was structured as a sale, the agreed price was paid by FC and the terms of the agreement did suggest the transaction was a sale. Also, legal title to the FB shares did pass to FC. Furthermore, a specific date was agreed upon fixing the time for recognition of the rights and obligations of the party, and the sale price was fixed.

However, a more detailed analysis of other terms of the purported sale suggest otherwise. As between FB and FC, FB bore the risk of loss and opportunity for gain. By entering into the put and call, FC gave up a portion of the opportunity for gain in return for protection from the risk of loss. In exchange for the elimination of risk of loss below the strike price of the put, FC gave up a portion of the opportunity for gain above the strike price of the call. When the price of the FB shares exceeded the strike price of the call, FB was able to exercise the call and any appreciation of the shares would inure to FB. However, the integrated forward feature acted to transfer a portion of the appreciation on the shares back to

FC if the share price rose above the levels specified above. FC also retained exposure to the risk of loss between the strike price of the call and put. However, when the options were first entered into, the strike price of the call is BCz and the strike of the put was BCaa. At that point, the spread of the collar (BCz-BCaa) was only ss percent of the share price. Furthermore, since the strike price of the call was below the current price of the shares, FC forfeited some of the opportunity for gain outside the spread. As previously mentioned, FC did have some opportunity for gain outside the spread through the integrated forward feature. Also, given that the put is significantly out of the money, FC retained little risk of loss on the shares. Therefore, FB, not FC, bore the risk of loss and the opportunity for gain.

In addition, FC and FB arguably did not intend for a sale of the shares to occur. When the options were entered into, the exercise price of the call was below the current price of the shares. The fact that the call was in the money suggests that there may have been a high probability that FB would exercise the call and retain ownership of the shares.

Although not all the factors point towards the conclusion that the transaction was not, in substance, a sale, based on the opportunity for gain and risk of loss, the intention of the parties, and the probability that the call would be exercised, FC should be treated as never having purchased the shares from FB.

A collar on shares, however, may act to transfer ownership of those shares. See Penn-Dixie Steel Corp. v. Commissioner, 69 T.C. 837 (1978); Rev. Rul. 72-543, 1972-2 C.B. 87. In Penn-Dixie Steel Corp., the taxpayer sought to treat a collar transaction as a sale, in part, because the possibility that a put and call would not be exercised was so remote that it should be ignored. The taxpayer had purchased stock and then sold a put and bought a call on the stock. The court disagreed with the taxpayer but assumed, without deciding, that there may have been a different result had the put and call both been exercisable and expired on the same date. The court also indicated that if the term of the put and call had been shorter the result may have been different. See Penn-Dixie Steel Corp., 69 T.C. at 844. FC's put and call are very short term and are both exercisable on the same date. Based on Penn-Dixie Steel Corp., by entering into the collar before purchasing the FB shares, FC, in substance, never acquired ownership of the shares. The collar negated any ownership acquired through the purchase of the shares.

Furthermore, a put option on stock may be treated as a sale of the stock when the option is certain to be exercised based on the economics of the option. Rev. Rul. 85-87, 1985-1 C.B. 268, treats a taxpayer that sold a significantly in-the-money put as entering into a contract to buy the shares. The revenue ruling determined there was no substantial likelihood the put would not be exercised based on the term of the put, the premium paid, the historic volatility in the value of

the stock, and the difference between the strike price of the put and the price of the shares at the time the put was entered into. Here, FC sold an in the money call, which, following the reasoning of Rev. Rul. 85-87, may be equivalent to a contract to sell the shares. Therefore, FC entered into a contract to sell the shares before they were purchased from FB. Had FC owned the shares, the transaction could be argued to be a sale of the shares. Since FC did not own the shares when the call option was sold, FC may be viewed as never having obtained possession of the shares. In addition, FB bought an in-the-money call, the equivalent, under Rev. Rul. 85-87, of a contract to buy. In essence, FB has contracted to buy back the shares before having sold them, which suggests FB never sold the shares to FC.

Finally, a transaction involving a sale of shares followed by the seller of the shares purchasing a call on those shares may not be treated as a sale of shares. See Comtel Corp. v. Commissioner, 376 F.2d 791 (1967). Here the initial seller of the shares, FB, has also purchased a call on the same shares, so FB should not be treated as selling the shares. If FB has not sold the shares, FC never owned the shares. Thus, if the shares were never owned by FC, the redemption is precluded.

ISSUE 2: If FC is treated as having properly acquired the shares of FB stock that were redeemed, whether FB's redemption of its stock held by FC is an exchange or a distribution to which section 301 applies.

A. Law.

A redemption of stock is an acquisition by a corporation of its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock. Section 317(b). If the redemption is any one of the four described in section 302(b), the redemption will be treated as a distribution in part or full payment in exchange for the stock. Section 302(a). If the redemption fails to satisfy any of these tests, section 302(d) provides that the redemption will be treated as a distribution of property governed by section 301. Those redemptions which qualify for exchange treatment include (1) redemptions that are not essentially equivalent to a dividend; (2) redemptions that are substantially disproportionate; and (3) redemptions that completely terminate the shareholder's equity interest in the corporation.[3] Section 302(b)(1), (2) and (3).

Section 318 provides constructive ownership rules in determining a shareholder's stock ownership for purposes of determining whether a redemption

[3] The fourth type of redemption (inapplicable in this case) which qualifies for exchange treatment is one undertaken in connection with a partial liquidation by a corporation. Section 302(b)(4).

satisfies the conditions of one of the paragraphs of section 302(b). Section 302(c). If any person owns, directly or indirectly, 50 percent or more in value of a corporation stock, such person is deemed to own the stock that such corporation owns, directly or indirectly, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation. Section 318(a)(2)(C). If any person owns, directly or indirectly, 50 percent or more in value of a corporation's stock, such corporation is deemed to own the stock that such person owns, directly or indirectly. Section 318(a)(3)(C). Finally, if any person has an option to acquire stock, that person is deemed to own such stock. Section 318(a)(4).

The step transaction doctrine has been applied to the characterization of a stock redemption under section 302. This judicial doctrine is a rule of substance over form that treats a series of formally separate steps as a single transaction if the steps are in substance integrated, interdependent, and focused towards a particular result. Penrod v. Commissioner, 88 T.C. 1415, 1428 (1987). Where a taxpayer has embarked on a series of transactions that are in substance a single, unitary, or indivisible transaction, the courts have disregarded the intermediary steps and have given credence only to the completed transaction. See Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652, 654 (5th Cir. 1968). In the case of a complete termination of the shareholder's interest, the termination need not result solely from the redemption, but rather from a combination of the redemption and other stock dispositions. See Commissioner v. Clark, 489 U.S. 726 (1989) (integrating a sale and redemption of stock to prevent dividend treatment); Zenz v. Quinlivan 213 F.2d 914 (6th Cir. 1954) (same); see also Rev. Rul. 77-226, 1977-2 C.B. 90 (holding that an integrated plan comprised of the partial redemption of stock, followed by the sale of the remainder of the stock to an unrelated third party, was a complete termination under section 302(b)(3)). The Zenz rationale is also applicable in determining whether a redemption is essentially equivalent to a dividend under section 302(b)(1). McDonald v. Commissioner, 52 T.C. 82, 87 (1969). Finally, the Service has approved the Zenz approach to section 302(b)(2) analyses. See Rev. Rul. 75-447, 1975-2 C.B. 113. The Zenz approach should also apply to a related termination of the stock ownership of a person whose stock ownership is attributed to the redeemed shareholder.

B. Analysis.

On the facts here, as part of the integrated plan, TP terminated the stock ownership in FB shortly after the redemption. Indeed, that termination was the purpose of all the steps. The individual steps of the Transaction took place according to a prearranged plan and required careful timing and documentation. Specifically, detailed instructions were given to each participant to execute various steps of the Transaction. First, the Engagement Letter referred to the steps of the Transaction as a Program. Second, the account value specified in the investment

advisory between FC and Promoter was equal to the amount specified in the warrant agreement for PRS to acquire FC warrants and the notional account value was equal to the amount of TP's gain that the Transaction was intended to offset. Third, FC's market risk on the FB stock was effectively eliminated based on the terms of the offsetting puts and calls and the reset price associated with the terms of the call option. Fourth, on different occasions Preparer and the Promoter each sent a letter to TP to remind him that one of the steps in the Transaction required him to personally acquire options to purchase FB stock equal to the FB shares redeemed. Fifth, TP acquired the options to purchase FB stock directly from FB and sold these options back to FB once the attribution was no longer required (i.e., after FB redeemed FC's FB stock), which was approximately two weeks after TP acquired the options. Sixth, TP sold most of its remaining FB stock approximately two weeks after FB redeemed FC's FB stock. Finally, PRS put the FC warrants back to FC during the same year that TP acquired the options and thereafter, it is our understanding that FC did not engage in any further business activity. Accordingly, the information we have at the present time demonstrates that (i) various steps were carefully timed to trigger artificial attribution (e.g., TP's simultaneous acquisition of out-of-the-money options to acquire v shares of FB stock on the date of FB's redemption of FC's v shares of FB stock); (ii) both FC and TP intended to dispose of their respective FB shares and options after a relatively short holding, but coordinated, period; (iii) PRS intended to dispose of the FC warrants soon after the artificial attribution was no longer required to assert the benefit of dividend treatment for FC; and (iv) the Transaction was carefully structured to limit FC's market risk in the FB stock as a result of the offsetting puts and calls.

Under the step transaction doctrine, TP and PRS, together with Promoter, FC, FP, FB and Administrator, embarked on a series of transactions that were in substance a single, unitary, or indivisible transaction. Indeed, the Engagement Letter describes the Transaction as the Program and subsequent reminder letters refer to TP's acquisition of options to acquire v shares in FB as "[o]ne of the steps occurring concurrently with the redemption." Therefore, the intermediary steps should be disregarded and only the completed transaction should be given credence. Specifically, PRS's acquisition and disposition of the FC warrants are intermediary steps of an integrated transaction that should be disregarded because the FC warrants were purchased pursuant to a prearranged plan for the sole purpose of triggering the artificial attribution of TP's options to acquire FB shares to FC in connection with the redemption. Moreover, PRS put the FC warrants back to FC once attribution was no longer required. Alternatively, TP's acquisition of options to acquire e shares of FB stock may be disregarded because TP purchased these options from FB for the sole purpose of triggering the artificial attribution and sold the identical options back to FB pursuant to a prearranged plan once

attribution was no longer required.[4] Thus, under either alternative, there could be no attribution of ownership that could lead to an allocation of FC's basis in its FB stock. Accordingly, FB's redemption of its stock from FC would be a complete termination of FC's interest in FB within the meaning of section 302(b)(3) pursuant to Clark, Zenz and Rev. Rul. 77-226 and, depending upon the fair market value of the FB stock and out-of-the-money options on the date TP subsequently disposes of such stock and options, TP could recognize gain. In other words, TP would neither realize nor recognize the claimed loss on the Transaction.

ISSUE 3: If FB's redemption of its stock held by FC is deemed to be a distribution to which section 301 applies, whether TP's adjustment to PRS's basis in FB stock was a "proper adjustment" within Treas. Reg. § 1.302-2(c).

A. Law.

Treas. Reg. § 1.302-2(c) provides that, where a redemption is treated as a dividend distribution, "proper adjustment" will be made to the basis of other stock held or treated as held by the redeemed shareholder. Treas. Reg. § 1.302-2(c) does not provide that, where a redemption is treated as a dividend distribution, basis will, in all cases, shift to such other stock. The regulations provide examples of proper adjustments. In Example 1, a corporation redeems 50 percent of a sole shareholder's stock. The redemption is treated as a dividend distribution, and the basis of the redeemed stock is added to the retained stock. Example 2 involves a situation in which a corporation's stock is held equally by a husband and wife, the husband's stock is completely redeemed, but the redemption is treated as a dividend distribution; the basis of the wife's stock in that corporation is increased by the husband's basis in the redeemed stock. Example 3 clarifies Example 2 by providing that, if the husband had retained any stock, his basis in the redeemed shares would have transferred to the basis of the shares of stock he retained.

A similar result is provided in the case of a dividend distribution under section 304. See Treas. Reg. § 1.304-2(c) Example (1) (providing that a shareholder who owns stock in both the acquiring corporation and the sold corporation ("issuing corporation") and is treated as receiving a dividend upon the sale of stock in a section 304 transaction may add its basis in the sold stock to the

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[4] In addition, we note that TP's acquisition of out-of-the-money FB options was traded on the same day as FB's redemption of FC's FB stock, but the trade had an effective date several days later. If the effective date of TP's acquisition of the out-of-the-money FB options means that TP acquired the benefits and burdens of ownership several days after the redemption, this appears to lend further support to the conclusion that attribution should not apply at all and that FB's redemption of FC's v shares of FB stock should be treated as a complete termination under section 302(b)(3).

basis of the stock in the acquiring corporation); Rev. Rul. 71-563, 1971-2 C.B. 175 (providing that a shareholder who directly owns stock *only* in the issuing corporation and is treated as receiving a dividend upon the sale of stock in a section 304 transaction may add its basis in the sold stock to the basis of the stock that it retains in the issuing corporation). Rev. Rul. 70-496, 1970-2 C.B. 74, however, provides that basis shifting is not permitted where a shareholder that is treated as receiving a dividend distribution in a section 304 transaction holds no stock directly in the acquiring corporation, illustrating that basis can disappear in cases where there is no appropriate shift.

B. Analysis.

TP claims that Example 2 of Treas. Reg. § 1.302-2(c) provides for a shifting of basis in these cases, but the Transaction at issue is distinguishable from that of Example 2 in Treas. Reg. § 1.302-2(c) in important ways. Although not explicitly stated, the example deals with the paradigm case involving taxpayers subject to U.S. tax on the distribution. In this situation, the redeeming shareholder is fully taxed, at ordinary rates, and without the benefit of any basis offset. Moreover, it is clear the rule is intended as a form of equitable relief--preserving, as near as possible, the benefit of the basis for the taxpayer.

In the Transaction, on the other hand, TP attempts to generate basis through transactions lacking business purpose and economic substance, and then shifts that basis from a person not subject to U.S. tax to a person that is subject to U.S. tax. The redeemed shareholder, FC, because it is not (and it must be assumed it never will be) subject to U.S. tax, is wholly indifferent to the U.S. tax treatment of the distribution and the loss of basis. FC is not in need of equitable relief. Indeed, by applying this equitable relief provision where none is necessary, there is an unintended windfall to TP claiming the shifted basis and thus increasing his basis in his FB stock. Accordingly, a basis shift in this case is not a “proper adjustment.”

In addition to the reasons discussed above, the basis adjustment sought in the present case is not a “proper adjustment” within the meaning of Treas. Reg. § 1.302-2(c) because, as discussed below, the Transaction as a whole lacks economic substance.

ISSUE 4: If TP’s adjustment to his basis in FB stock was a “proper adjustment”, whether TP’s stock loss was not a bona fide loss with the result that the purported stock loss is disallowed under section 165.

Section 165(a) provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Treas. Reg. § 1.165-1(b) provides that to be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed

transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and Treas. Reg. § 1.165-11 (relating to disaster losses), actually sustained during the taxable year. Treas. Reg. § 1.165-1(b) further states that only a bona fide loss is allowable and that substance and not mere form shall govern in determining a deductible loss. See also ACM Partnership v. Commissioner, 157 F.3d 231, 252 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999) ("Tax losses such as these . . . which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations.").

As discussed below, the Transaction lacks economic substance. The Transaction is no more than a series of contrived steps that effect an artificial loss on PRS's disposition of FB stock. The stock loss is not bona fide and does not reflect actual economic loss. Consequently, the loss should be disallowed under section 165.

ISSUE 5: If TP's adjustment to its basis in FB stock was a "proper adjustment", whether TP (through PRS) acquired control of FC with a principal purpose of avoiding or evading Federal income tax with the result that the purported stock loss is disallowed under section 269.

A. Law.

Section 269 provides that if any person acquires, directly or indirectly, control of a corporation and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance may be disallowed.

The first requirement is that a "person" be involved. "Person" is broadly defined as an individual, trust, estate, partnership, association, company, or corporation. Treas. Reg. § 1.269-1(d).

The next requirement is that the person acquire control of a corporation. Section 269(a) defines "control" as the ownership of stock representing at least 50 percent of the total combined voting power of all classes of stock or at least 50 percent of the value of all classes of stock. The "acquisition of control," however, may be direct or indirect. Acquisition of control occurs when one or more persons acquire beneficial ownership of stock representing the requisite control. Treas. Reg. § 1.269-5(a). That is, so long as the person has beneficial ownership of the equity of the corporation, record ownership is unnecessary. See Ach v. Commissioner, 358 F.2d 342, 346 (6th Cir. 1966) (holding that beneficial ownership constituted ownership within section 269 and record ownership was unnecessary); Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025, 1031 (1976) (finding

that traditional ownership attributes such as legal title, voting rights, and possession of stock certificates were not conclusive as to the ownership of stock); Rev. Rul. 70-638, 1970-2 C.B. 71 (citing Ach, holding that acquisition of control occurred when beneficiaries of a trust acquired both direct stock ownership in the corporation and indirect ownership as beneficiaries of the trust). The ownership of stock should represent the ownership of the equity of a corporation and reflect a risk investment. Thus, the acquisition of stock means that the purchaser has assumed the risks of an investor in equity. See John Kelly Co. v. Commissioner, 326 U.S. 521, 530 (1946); Zilkha and Sons, Inc. v. Commissioner, 52 T.C. 607, 613 (1969), acq., 1971-1 C.B. xvi; Rev. Rul. 68-18, 1968-1 C.B. 5.

Furthermore, such equity ownership must reflect effective control over the business and management of the corporation. In Briarcliff Candy Corp. v. Commissioner, T.C. Memo 1987-487, the court considered whether section 269 applied to a loss corporation's ("petitioner") acquisition of a profitable subsidiary ("target"). As part of the transaction, the target underwent a recapitalization. The petitioner acquired stock representing at least 50 percent of the total combined voting power of all classes of stock entitled to vote and the parent corporation of the target acquired convertible junior preferred shares, which, if converted, would have represented 95 percent of the total combined voting power over the target. The court found that it was questionable whether the petitioner had acquired control for purposes of section 269 given that the parent corporation maintained effective control over the business and management of the target. This finding suggests that a holder of convertible securities, and presumably similar equity stakes such as options, may be considered to have acquired control if the holder has effective control over the business and management of the acquired corporation.

Finally, an option holder also may be viewed as acquiring control and assuming the benefits and burdens of ownership of the corporation's stock if the option holder has furnished or will furnish substantially all of the funds at risk (other than a nominal amount contributed by the legal owner) and only the option holder's investment (not that of the legal owner) will appreciate or depreciate. See, e.g., Tennessee Natural Gas Lines v. Commissioner, 71 T.C. 74, 83 (1978), acq., 1979-2 C.B. 2.; Rev. Rul. 82-150, 1982-2 C.B. 110 (concluding that a holder of deep-in-the-money options is the owner of the referenced property).

The final requirement of section 269 is that the acquisition of control must have occurred for the principal purpose of evasion or avoidance of Federal income tax. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. Treas. Reg. § 1.269-3(a). This determination is a factual one which requires a subjective evaluation of the taxpayer's motives. See Briarcliff Candy Corp., supra.

B. Analysis.

In the Transaction, PRS, a partnership, is clearly a “person” for purposes of section 269. TP, an individual in control of PRS, would also qualify as a “person” for purposes of section 269.

TP also acquired requisite control of FC. First, TP clearly acquired beneficial ownership of FC stock. Although TP acquired options to convert the FC warrants into FC stock, the options represented at least 50 percent of FC’s total combined voting power of all classes of stock.

In addition, TP exercised effective control over the business and management of FC. FC did not appear to have engaged in any appreciable activity other than the transactions required to generate the inappropriate tax benefit afforded to TP. That is, FC’s “business” activities were solely for the benefit of TP.

Finally, TP assumed the benefits and burdens of ownership because TP appeared to have provided all of the funds at risk and only TP’s investment likely will appreciate or depreciate. As noted above, PRS paid $f to acquire FC warrants and would have had to pay a strike price of approximately $ii to convert the FC warrants into FC stock. By comparison, FP made a capital contribution of $f upon formation of FC, but the entire $f was immediately loaned back to FP in exchange for an interest-free demand note with principal due and payable on Date 5. Thus, FP’s amount at risk in its investment in FC was substantially less than the stated principal amount of the demand note because the interest-free nature of the loan payable on Date 5 caused the loan’s present value of such loan to be considerably less than the stated amount.[5] Moreover, based on the terms of the warrant agreement and FC’s organizational minutes, only TP was entitled to benefit from its additional capital contribution. Specifically, if PRS formally converted the FC warrants into FC stock, FP would have been entitled to put its FC stock back to FC in exchange for the cancellation of its demand note plus an additional $d fee.[6] Similarly, if PRS put the FC warrants back to FC, TP would also receive the liquidation value of FC less cancellation of the demand note plus a $d fee which FP would presumably receive upon liquidation of FC. In either event, regardless of whether TP exercised its call right or put right, FP would receive the same

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[5] FC’s distribution of the $f shortly after FP’s contribution of such amount in exchange for a m-year, interest-free, demand note suggests that this transaction is a sham and may also suggest that FP is a sham. See discussion in Issue 7 below.

[6] We recommend that additional facts be developed to determine whether there was an understanding, express or implied, that FP would put its shares to FC if TP converted its FC warrants into stock.

approximately $d fee and TP would be entitled to any appreciation or would suffer any depreciation in the value of FC's assets. Accordingly, contrary to the normal case of a shareholder relationship with a corporation, FP had no real claim on FC's equity if FP could not participate in the appreciation to FC's assets.[7] Similarly, if TP puts the FC warrants back to FC, TP would also receive the liquidation value of FC. Regardless of whether TP exercised its put right, TP would be entitled to any appreciation or would suffer any depreciation in the value of FC's assets. Thus, TP acquired the requisite control over FC.

Finally, TP acquired control over FC for the principal purpose of avoiding or evading Federal income tax. Based on the documents provided to us, TP has not shown any other valid and substantiated purpose for engaging in the Transaction other than for the avoidance or evasion of Federal income tax. See also the discussion in Issue 7.B below. In addition, the Transaction and the various steps of the Transaction had no economic substance and had relatively insignificant economic consequences, as discussed more fully below in Issue 7.a. Thus, even if TP's adjustment to PRS's basis in FB stock was a "proper adjustment," since TP acquired control over FC for the principal purpose of avoiding or evading Federal income tax, the loss resulting from PRS's sale of FB stock and options and reported by TP on his return should be disallowed under section 269.

ISSUE 6: Whether section 482 applies to reallocate any FB stock basis or loss claimed attributable to FC's basis in the FB stock to FC.

The Service should argue, as a back-stop position, that if basis is assumed to shift from FC to TP under Treas. Reg. § 1.302-2(c), such basis may be allocated from TP to FC under section 482, in order to prevent the evasion of taxes or clearly to reflect TP's income.

A. Law and Analysis.

Section 482 provides in relevant part:

> In any case of two or more organizations, trades, or businesses . . . owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or

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[7] Finally, the Engagement Letter states that TP intends to purchase a warrant to acquire a controlling interest in FC in connection with the Program and that FC may pay fees to FB, Promoter, legal counsel, and Preparer in amounts which may be more, less or equal to the warrant price in FC, the excess of which was the responsibility of TP, in consideration of the services rendered in structuring, facilitating and executing the Program.

> allowances between or among such organizations, trades, or businesses if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.[8]

Section 482 was designed to prevent the artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises. Commissioner v. First Security Bank of Utah, N.A., 405 U.S. 394, 400 (1972); Barford v. Commissioner, 194 F.3d 782, 786 (7th Cir. 1999); Charles Town, Inc. v. Commissioner, 372 F.2d 415, 419 (4th Cir. 1967) cert. denied, 389 U.S. 841 (1967); Ach v. Commissioner, 42 T.C. 114, 125 (1964), aff'd, 358 F.2d 342 (6th Cir. 1966), cert. denied, 385 U.S. 899 (1966). Cf. H.R. Rep. No. 2, 70th Cong., 1st Sess., 16-17.

Treas. Reg. § 1.482-1(a)(2) provides that, if a controlled taxpayer has not reported its true taxable income, the Service

> may allocate income, deductions, credits, allowances, basis, or any other item or element affecting taxable income (referred to as allocations). The appropriate allocation may take the form of an increase or decrease in any relevant amount.

Treas. Reg. § 1.482-1(f)(1)(iii) provides that

> If necessary to prevent the avoidance of taxes or to clearly reflect income, the district director may make an allocation under section 482 with respect to transactions that otherwise qualify for non-recognition of gain or loss under applicable provisions of the Internal Revenue Code (such as section 351 or 1031).

This principle is illustrated by an example in which the district director may, to determine true taxable income, disallow the loss claimed by a corporate taxpayer on the sale of stock that it received with a built-in loss from its parent corporation in a section 351 transaction. Treas. Reg. § 1.482-1(f)(1)(iii)(B).

1. Two or More Organizations, Trades, or Businesses.

A threshold requirement of section 482 is that "two or more organizations, trades, or businesses" be involved before the section can be applied. These terms are defined very broadly by the regulations. Treas. Reg. §§ 1.482-1(i)(1) and (2).

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[8] For purposes of section 482, the term "evasion of taxes" is synonymous with "tax avoidance." Foster v. Commissioner, 80 T.C. 34, 157-158 (1983).

These definitions would appear to cover all of the participants in the transaction, including cases in which the taxpayer is an individual. See, e.g., Powers v. Commissioner, 724 F.2d 64, 66 (7th Cir. 1983) (allocation between an individual and a corporation under the individual's control). In the present case, the two or more organizations, trades, or businesses requirement is satisfied because the activities are conducted through PRS, a partnership.

2. Control.

Treas. Reg. § 1.482-1(i)(4) defines "controlled," for purposes of section 482, to include

> any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

Case law supports this broad definition of control, indicating, for example, that actual and practical control, rather than legally enforceable control, is what counts in the application of section 482. Ach v. Commissioner, supra, at 125; Grenada Indus., Inc. v. Commissioner, 17 T.C. 231 (1951), aff'd, 202 F.2d 873 (5th Cir. 1953), cert. denied, 346 U.S. 819 (1953), acq. in part and nonacq. in part, 1952-2 C.B. 2, 5. See also Appeal of Isse Koch & Company, Inc., 1 B.T.A. 624, 627 (1925), acq., 1925-1 C.B. 2 ("[C]ontrol not arising or flowing from legally enforceable means may be just as effective in evading taxation as if found on the most formal and readily enforceable legal instrument."); DHL Corp v. Commissioner, T.C. Memo 1998-461 (1998) (holding that foreign investors did not have section 482 control over a corporation despite their ability to appoint a majority of its board of directors because domestic shareholders retained the ability to control day-to-day operations and major events); Charles Town, Inc. v. Commissioner, 372 F.2d 415, 419 (4th Cir. 1967), aff'g, T.C. Memo. 1966-015, cert. denied, 389 U.S. 841 (1967) (holding that two shareholders were in control of a corporation in which they owned only two percent of the outstanding stock because of their possession of effective and practical control over the corporation).

Case law is also in accord with the presumption of control that arises when there has been an arbitrary shifting of income or deductions. DHL Corp v. Commissioner, supra, T.C. Memo. 1998-461 at 100 (When the interests controlling one entity and those controlling another have a common interest in shifting income from the former to the latter, entities may be considered commonly controlled.). See also Dallas Ceramic Co. v. Commissioner, 598 F.2d 1382, 1389 (5th Cir. 1979), rev'g, 35 A.F.T.R.2d (RIA) ¶ 75-394 (N.D. Tex. 1974) (holding that the government

correctly argued that proof of a shifting of income between two corporations establishes a presumption of common control under section 1.482-1(a)(3) (1968) - predecessor to current section 482 regulations); Hall v. Commissioner, 294 F.2d 82, 85 (5th Cir. 1961), aff'g, 32 T.C. 390 (1959), acq., 1959-2 C.B. 4 (finding presumption of control under section 29.45-1 of Regulation 111 - predecessor to current section 482 regulations).

There appear to be several theories under which ownership or control could be found to exist for purposes of applying section 482 with respect to the transaction in this case, which involves Promoter, TP, PRS, FC and FP. These theories include ownership (or control based on ownership); control based on managerial control; control based on a presumption arising from parties acting in concert with a common goal; and ownership or control arising from a combination of factors under any or all of these theories. See, e.g., W.L. Gore & Associates v. Commissioner, T.C. Memo. 1995-96, in which the Commissioner put forward three specific bases for showing, at trial, that there was control for purposes of section 482: (1) taxpayer's ownership interests, (2) taxpayer's managerial control, and (3) an arbitrary shifting of income between taxpayer and another party. In addition, the Commissioner raised the issue of control under the "common objective" theory. The Tax Court, in denying summary judgment, stated:

> We reject [taxpayer's] attempt to deal separately with each of the three prongs of [the Commissioner's] position in respect of control . . . . The fact of the matter is that there is a confluence among the three prongs which can, depending upon the evidence at trial, produce a result which would not necessarily follow from their separate consideration. This may well be a situation where the whole is more than the sum of its parts.

Id. at 14. The Tax Court also held that the Commissioner had preserved the right to argue at trial that the facts in the case supported a finding of control under the "common objective" theory. Id. at 9. Moreover, we believe that where FP's and FC's participation and activities associated with the Transaction were dictated or crafted by TP, such direction on the part of TP would form a separate basis for control. Accordingly, facts of the Transaction, described above, would demonstrate ownership or control for purposes of section 482, as in W.L. Gore, under one or more of several overlapping and complementary theories.

a. Actual Control.

The Transaction's various steps, which take place according to a prearranged plan, require careful timing and documentation, involve multiple participants, would not have occurred except under the effective managerial direction and control of the Promoter, Preparer and TP. For example, we

understand that FC and FP, were formed solely for the purpose of engaging in the Transaction, so that not only the steps of the Transaction that they were required to perform, but their very existence, were caused to occur by the Promoter, Preparer and TP. In effect, the only day-to-day activities of FC and FP were likely to have been limited to those that related to the Transaction, as to which the Promoter and TP were in control. Similarly, each of the coordinated steps of the Transaction was carried out by the various participants pursuant to the direction and control of the Promoter, Preparer, and TP. Specifically, detailed instructions were given to each participant, both in advance and when the time for it to act approached, regarding what the participant had to do with respect to each step of the Transaction. For example, each of Promoter and Preparer reminded TP that one of the steps occurring concurrently with the redemption was that TP needed to acquire options to acquire the same number of FB shares. Thus, it should be possible to show that the steps that comprise this Transaction would not have taken place but for the effective managerial direction and control exercised by the Promoter, Preparer and TP. Therefore, in carrying out the Transaction, TP, PRS, Promoter, Preparer, FC and FP may all be regarded as controlled participants.

b. Acting in Concert.

There appears to be little room for doubt that TP and the other participants in the Transaction acted pursuant to a common plan to shift FC's basis in the FB stock to TP, designed with the objective of enabling TP to claim a large capital loss on the sale of its FB stock and for others to receive fees from funds provided by TP. For example, TP entered into the Transaction only after having recognized a large capital gain under the belief that it would be in a position to avoid payment of U.S. tax by virtue of claiming a large capital loss. That this is the common goal of all of the participants in the Transaction should also be shown by the fact that no other goal for the interrelated steps of the Transaction is evident. For example, no purpose would seem to be served by timing FB's redemption of FC's FB stock to coincide with TP's purchase of an equal amount of FB stock options, other than the common purpose of having the redemption treated as a dividend and seeking to rely on the section 302 regulation to shift FC's basis in FB stock to TP. Finally, each of Promoter, FP, FB, Preparer, among others, received substantial fees for their participation in the Transaction.

c. Income or Deductions Arbitrarily Shifted.

Where the Service seeks to establish common control due to the presence of an artificial shifting of income and deductions, it is the Service's burden to prove the applicability of section 482 by establishing a shifting of income and deductions. Dallas Ceramic Tile Co., 598 F.2d at 1390. We believe this burden is met by the TP, FC, FB, Preparer and Promoter acting in concert intentionally to create phantom dividend income to FC (on which it is not subject to U.S. tax) and to shift

the basis of FB stock to TP to create an artificial loss for TP (for U.S. income tax purposes) equal to the phantom income of FC. FC's dividend income is "phantom" because FC does not realize any economic gain to correspond with its deemed dividend income. Similarly, TP's claimed loss on the sale of its FB stock is "artificial" because it did not have any economic cost to correspond with its claimed basis in FB stock that is claimed to have shifted from FC to TP. We note that, notwithstanding any slight profit motive FC might have had to invest in FB stock, it is clear that the major impetus for FC to acquire FB stock was to obtain a basis in that stock to be shifted to TP, so as to allow TP to claim an artificial loss to offset its taxable gain from unrelated transactions. Accordingly, a presumption of control arises since the FC's basis in FB stock was arbitrarily shifted to create an artificial loss for TP. See Treas. Reg. § 1.482-1(i)(4).

d. Ownership.

For the reasons discussed more fully in Issue 7.B below, TP should be treated as, in fact, the majority owner of FC with respect to the Transaction based on the doctrine of substance over form. Such actual ownership of FC by TP could support application of section 482 under its ownership standard and could reinforce a finding of actual control under its control standard.

3. The Same Interests.

The regulations do not provide guidance on the meaning of the term "the same interests," as used in section 482. However, case law indicates that, in using the term "the same interests," Congress intended to include more than "the same persons" or "the same individuals." Brittingham v. Commissioner, 598 F.2d 1375, 1379 (5th Cir. 1979), citing, H. Rept. No.2, 70th Cong., 1st Sess. (1927), 1939-1 C.B. (Part 2) 384, 395; S. Rept. No. 960, 70th Cong., 1st Sess. (1928), 1939-1 C.B. (Part 2) 409, 426. See also H. Rept. No. 350 and S. Rept. No. 275, 67th Cong., 1st Sess. (1921); Ach v. Commissioner, 42 T.C. 114, 125 (1964), aff'd, 358 F.2d 342 (6th Cir.), cert. denied, 385 U.S. 899 (1966). See also B. Forman Co., Inc. v. Commissioner, 598 F.2d 1144 (2d Cir. 1972), cert. denied, 407 U.S. 934 (1972) (rejecting Tax Court's view that two independently owned corporations acting in concert to make interest-free loans to a jointly owned corporation did not constitute the same interests within the meaning of section 482); South Texas Rice Warehouse Co. v. Commissioner, 366 F.2d 890, 894-5 (5th Cir. 1966), aff'g, 43 T.C. 540 (1965), cert. denied, 386 U.S. 1016 (1967) (different persons with a common goal or purpose for artificially shifting income can constitute the "same interests" for the purposes of the statute). Cf. Appeal of Rishell Phonograph Co., 2 B.T.A. 229, 233 (1925) ("If 'the same interests' was intended to mean only 'the same persons,' it would have been easy for Congress, by using the latter term, to have avoided all ambiguity."). See also LXI-Part 6 CONG. REC. 5827 (1921)

(statement of Sen. King referring to the "same forces" controlling a number of corporations).

Thus, it is not necessary that the same person or persons own or control each business before section 482 can be applied. Where there is a common design for the shifting of income, different entities may constitute the "same interests." This basis for finding the existence of the "same interests" is identical to the basis on which control may be found to exist under the regulations and case law. Thus, if there is a common design for shifting income or deductions, then the requirements for control and same interests may be met. See Hall v. Commissioner, supra, 32 T.C. at 409-10 (An arbitrary shifting of income coupled with the ability to direct the actions of an entity establishes control for the purposes of section 482 -- whether or not ownership exists.). Consequently, none of the participants in this transaction is required to have majority ownership of another participant's voting stock or to have the legal right to direct another participant's actions in order for control to exist for purposes of section 482. The Service has the authority to determine whether control exists for this purpose by considering the reality of the situation and examining whether the same interests effectively control the participants to the transaction involved.

4. Economic Substance and Clear Reflection of Income.

Once the Secretary has proven that the parties to the Transaction are owned or controlled by the same interests, he "may distribute, apportion, or allocate . . . deductions . . . between or among such organizations, trades or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades or businesses." Section 482. Generally, the Commissioner's determinations under section 482 must be sustained absent an abuse of discretion. G.D. Searle and Co. v. Commissioner, 88 T.C. 252, 358 (1988). The taxpayer must meet a heavier than the normal burden of proof and demonstrate that the Commissioner's determinations are arbitrary, capricious, or unreasonable in order for the courts to set aside the Commissioner's determinations. Id.

a. Economic Substance/Tax Evasion.

When analyzing potential tax avoidance aspects of a transaction, the Commissioner will respect the transaction's contractual terms if consistent with the true economic substance of the transaction. Treas. Reg. § 1.482-1(d)(3)(ii)(B). The economic substance standard of the regulations overlaps with the economic substance and sham transaction doctrines developed in case law which allow the Service to consider the economic realities of a transaction and disregard transactions lacking a business purpose and entered into solely for tax avoidance

motives.[9] However, the section 482 regulations expand upon case law guidance. Specifically, the regulations provide the following:

> The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties . . . . If the contractual terms are inconsistent with the economic substance of the underlying transaction, the district director may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

Treas. Reg. § 1.482-1(d)(3)(ii)(B). Thus, section 482 provides an alternative approach for challenging a transaction for lack of economic substance by providing additional criteria under which to apply the economic substance and sham inquiries to the parties' conduct and not restricting the Service's allocation authority to instances of "colorable" or "sham" transactions.

Under the first section 482 analysis, the economic substance of a transaction is analyzed by focusing on the parties' actual conduct; the economic risks purportedly transferred; and whether, from a business perspective, the transaction makes objective business sense. See Treas. Reg. § 1.482-1(d)(3)(ii)(B). Where the economic substance of a transaction is inconsistent with the parties' purported characterization, the Service may disregard the contractual terms underlying the transaction and treat the transaction consistent with its economic substance. This treatment may result in a denial of deductions arising from the transaction at issue. See e.g., B. Forman, 453 F.2d at 1160-61; Medieval Attractions N.V. v. Commissioner, T.C. Memo 1996-455.

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[9] See Gregory v. Helvering, 293 U.S. 465 (1935); Knetch v. Commissioner, 364 U.S. 361 (1960) (interest deductions disallowed where nothing of substance could be realized from the transaction other than a tax deduction); Frank Lyon Co. v. U.S., 435 U.S. 561, 572 (1978) ("The simple expedient of drawing up papers" is not controlling for tax purposes when the objective economic realities of a situation are to the contrary); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) (transaction is a sham where taxpayer is motivated by no business purposes other than obtaining tax benefits in entering a transaction and where transaction has no economic substance because no reasonable possibility of profitability exists); ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3rd Cir. 1998), cert. denied, 526 U.S. 1017 (1999) (transaction devoid of economic substance cannot be the basis for a deductible loss).

The Service should disregard the contractual terms underlying the Transaction and treat the Transaction consistent with its economic substance by denying Taxpayer's reported tax loss for two reasons. First, the facts indicate that there was a common tax avoidance scheme among the participants to shift income and/or deductions arbitrarily and TP's reported tax loss was wholly unrelated to TP's economic gain or loss with respect to the Transaction. The parties have attempted to characterize this transaction as involving a purchase of v shares of FB stock. However, the true substance of this transaction is not consistent with the parties' characterization of it as a stock purchase transaction. On the date that FC purchased its FB shares, it only had $o of funds. Consequently, FC did not have the financial capacity to pay the purchase price of the stock. However, because of the delayed settlement agreement, FC was able to offset its purchase obligation for the v FB shares by the payments FB was required to make under the call option. Because TP's $o was the only source of funds for FC, the only way FC could meet its payment obligation was if FB offset FC's payment obligation by redeeming the stock through its exercise of the call option. The deferral of the settlement date until the exercise date of the call option allowed FC to retain its basis in the stock without the corresponding obligation of having to make a substantial cash investment.

Therefore, in substance, FC did not truly purchase the FB stock. Because FB's right to receive payment for the shares did not arise until the exercise date of the call option and the call option was likely to be exercised to allow an offsetting of the purchase price, FB can be viewed as remaining the true owner of the shares, rather than FC. Pursuant to the authority of Treas. Reg. § 1.482-1(d)(3)(ii)(B), the Service may disregard the contractual terms of the transaction which occurred between FB and FC, which the parties deemed to be a stock purchase, because their conduct is not indicative of a purchase actually occurring. Disregarding the purported stock purchase transaction would result in denying FC a basis in the v FB shares. Consequently, FC would have no basis to shift to TP and could not apply the provisions of Treas. Reg. § 1.302-2(c). Accordingly, the loss TP claimed on the sale of its FB shares which was solely attributable to FC's shifted basis will be disallowed and TP will have to recognize a gain on the FB stock sale. Additionally, TP's basis in the call option will be reduced to its original basis, thus reducing its loss on the option.

Second, the Transaction appears to lack a business purpose and appears to have been entered into solely for tax avoidance motives. Moreover, the contractual terms are inconsistent with the economic substance of the underlying transaction. Therefore, the Service may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

Although the parties have attempted to characterize this transaction as involving a purchase of g FC warrants, the true substance of this acquisition

appears to be a stock purchase and FC appears to be a sham entity. First, for the reasons discussed in Issue 7.B below, PRS's acquisition of FC warrants should be treated as an acquisition of stock because PRS paid more than the required purchase price and, under the terms of the warrant agreement and the organizational documents, it was likely that only PRS would be entitled to any appreciation, or would suffer any depreciation, in the FC assets. Moreover, PRS paid $tt more for the FC warrants than it was obligated and, pursuant to the Engagement Letter between PRS and Preparer, TP and PRS were obligated to pay any fees and expenses incurred by FC in excess of the warrant price. Second, for the reasons discussed in Issue 7.B below, FC should be treated as a sham entity because it has no business purposes other than tax avoidance by facilitating the artificial shifting of basis from FC to PRS and by serving as a conduit for the payment of all expenses associated with the Transaction whose sole purpose was to create a tax (but not economic) loss by artificially shifting basis from FC to PRS. Accordingly, PRS should be viewed as the owner of FC (not FP) and, because FC is a sham entity, there could be no attribution of ownership that could lead to an allocation of FC's basis in its FB stock to PRS under Treas. Reg. § 1.302-2(c).

b. Clear Reflection of Income.

Even in the absence of tax avoidance motives, the Commissioner may make a section 482 allocation if necessary to clearly reflect income. Courts have sustained the Commissioner's authority under section 482 in cases that have involved, essentially, a conflict between the result under section 482 and the result that would otherwise be reached under a nonrecognition provision of the Code. This line of cases includes National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), cert. denied, 320 U.S. 794 (1943), which is referred to by Treas. Reg. § 1.482-1(f)(1)(iii). However, courts have been sensitive to the tension between the broad principles of section 482 and the fact that a different result may be provided for by a specific nonrecognition provision.[10] Courts in these cases have explained in various ways the circumstances that will justify use of section 482 to override a nonrecognition provision.

This case involves the use of the Commissioner's authority under section 482, as reflected by Treas. Reg. § 1.482-1(a)(2), to allocate, among other items, "basis." Use of this authority in the context of Treas. Reg. § 1.302-2(c), which provides for a "proper adjustment" of basis, may be based either on the conclusion

[10] Most cases involving section 482 relate to whether an arm's length amount of consideration has been paid and involve primarily questions of valuation and not whether a taxpayer is entitled to a different result under another provision of the Code, such as a nonrecognition provision, or under a regulation, such as the section 302 regulation in this case.

that the tax avoidance and clear reflection of income principles of section 482 should be applied in determining whether an adjustment under Treas. Reg. § 1.302-2(c) is "proper," or that the section 482 principles should be applied to override the results of an adjustment that would otherwise be allowed under Treas. Reg. § 1.302-2(c).

Either approach would need to be supported by an analysis of the purpose and intended scope of the basis adjustment provided for by Treas. Reg. § 1.302-2(c) and the factors that would make an adjustment inappropriate under the facts of this Transaction.

We caution, however, that use of section 482 in this case would be novel because it would be with respect to a transaction that, in accordance with the assumption stated above, might arguably otherwise have a different result under a specific regulation, Treas. Reg. § 1.302-2(c). However, if a tax avoidance motive for the transaction is established, courts have permitted section 482 to deny income and loss shifting that is sanctioned under another provision. See, e.g., National Securities Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943), cert. denied, 320 U.S. 794 (1943). Although this principle has only been used in the nonrecognition transaction context, e.g., sections 351 and 721, an argument can be made that the principle should apply to Treas. Reg. § 1.302-2(c).[11]

This is an approach that has been used by courts in analyzing whether to apply section 482 to override the results that would otherwise be reached in cases involving nonrecognition provisions of the Code. In such cases, courts have viewed the nonrecognition provisions of the Code as involving a form of income distortion that has been specifically authorized by Congress. Under this view, the clear reflection prong of section 482 should not be used to override a nonrecognition provision, since a failure clearly to reflect income is inherent in transactions that qualify for nonrecognition treatment. For this reason, use of section 482 to override a nonrecognition provision may be limited to those cases in which the court finds that the nonrecognition transactions in question are "tainted" by tax evasion or avoidance purposes. See, e.g., Ruddick Corp. v. United States, 643 F.2d 747, 752 (Cl. Ct. 1981), on remand, 3 Cl. Ct. 61, 65 (1983), aff'd without op., 732 F.2d 168 (Fed. Cir. 1984). By analogy, the tax avoidance aspects of this transaction, as discussed in this memorandum, would support application of section 482 principles to prevent or to override the basis adjustment claimed by taxpayers under Treas. Reg. § 1.302-2(c).

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[11] Other sections of the regulations specifically allow for section 482 to work conjunctively with their provisions providing for special allocations. See, e.g., Treas. Reg. § 1.704-1(b)(2)(iii).

We view the circumstances of this Transaction to be such that use of section 482 is fully justified in order to prevent “allowing taxpayers to take full advantage of tax schemes permitted by literal terms of the Code [or, in this case, the regulations].” Eli Lilly & Co. v. Commissioner, 856 F.2d 855, 861 (7th Cir. 1988).

Treas. Reg. § 1.482-1(a)(2), provides that an allocation under section 482 “may take the form of an increase or decrease in any relevant amount,” and authorizes the Service to allocate any item or element affecting taxable income, including “deductions” and “basis.” Thus, with respect to this Transaction, an allocation under section 482 could disallow TP’s deduction of the shifted basis in TP’s computation of gain or loss on the sale of its FB stock, and the Service could allocate that basis back to FC. See, e.g., Northwestern Nat. Bank v. United States, 556 F2d 889, 892 (8th Cir. 1977) (section 482 applied to disallow a charitable deduction by a parent corporation and to reallocate the deduction to its subsidiary corporation).

Finally, we note that use of section 482 to reallocate basis would be unnecessary if the Service is successful in establishing that no basis shift occurs with respect to the Transaction because, for example, the Transaction is a sham. However, as indicated above, the broad principles of section 482, under which the Commissioner is given authority to make adjustments in the tax attributes of related parties, might be invoked to support other arguments against the claim that there is a basis shift with respect to the Transaction. For example, the language of Treas. Reg. § 1.302-2(c) that provides for a “proper adjustment of the basis of the remaining stock,” could be viewed as intended to apply only where such an adjustment will result in a clear reflection of income. An adjustment would not be proper, under this view, if it were to result in an evasion of taxes or a failure clearly to reflect the income of parties who are related because of section 318 ownership attribution.

B. Conclusion.

We consider section 482 to be appropriate authority for the Service to use in challenging the Transaction. There are three ways in which section 482 could be used. First, section 482 principles might be invoked to support the argument that the language of Treas. Reg. § 1.302-2(c) providing for a “proper adjustment of the basis of the remaining stock” applies only where necessary to assure a clear reflection of income. Second, under the economic substance or tax evasion standard discussed above, the Service could argue, as a back-stop position, that the Transaction should be recharacterized in accordance with its economic substance. Finally, assuming a court might find that Treas. Reg. § 1.302-2(c) allows a basis shift as claimed by TP, the Service could argue, as a back-stop position, that section 482 should be applied to clearly reflect TP’s income by

disallowing TP's deduction of the shifted basis in computing its gain or loss on PRS's sale of FB stock and to reallocate the shifted basis from TP back to FC.

ISSUE 7: Whether the Transaction may be disregarded, in whole or in part, under the economic substance doctrine.

The incidence of taxation depends on the substance of a transaction. Gregory v. Helvering, 69 F.2d 809 (2d Cir. 1934), aff'd 293 U.S. 465 (1935); Commissioner v. Court Holding, 324 U.S. 331 (1945). In evaluating the validity of a transaction, courts typically attempt to determine, first, whether a transaction genuinely occurred or whether it was merely "papered" in order to generate unwarranted tax benefits. Transactions that are found to be factual shams are, of course, disregarded. See, e.g., Malden Knitting Mills v. Commissioner, 42 T.C. 769 (1964). A transaction that is found to have genuinely occurred must be analyzed further to determine whether it possessed economic substance. Because the sham in fact analysis is highly factual, the discussion following the economic substance analysis assumes that each of the steps of the Transaction genuinely occurred.[12]

A. Disregarding the Transaction as a whole under the economic substance doctrine.

1. Law.

Generally, an economic substance analysis looks to the subjective business purpose and the objective profit potential of the transaction. See Rice's Toyota World, Inc. v. Commissioner, 81 T.C. 184 (1983), aff'd in relevant part, 752 F.2d 89 (4th Cir. 1985); ACM Partnership v. Commissioner, 157 F.3d 231 at 247 (3rd. Cir. 1998). These two aspects of the economic substance inquiry do not constitute a rigid two-step test, but rather represent related factors, both of which inform the analysis. ACM, supra at 247.

Various articulations of the subjective prong of the economic substance analysis have been set forth by the courts. See, e.g., ACM, 73 T.C. Memo. at 2217 (whether the transaction is "rationally related to a useful nontax purpose . . . in light of the taxpayer's economic situation and intentions"); ACM, 157 F.3d at 253 ("whether the transaction was intended to serve any useful non-tax purpose"); Rice's Toyota World, 752 F.2d at 91 (whether "the taxpayer was motivated by no business purpose other than obtaining tax benefits in entering in the transaction"); Yosha v. Commissioner, 861 F.2d 494, 501 (7th Cir. 1988) ("Judges can't peer into

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[12] We recommend that the facts of each case be evaluated to determine whether each step of the Transaction actually occurred. If not, a sham-in-fact argument may be available.

people's minds or 'weigh' motives . . . . Rather, the usual approach is to focus the analysis on whether any non-tax goals or functions were or plausibly could have been served by the action."). The common thread of these articulations, however, is whether the transaction had a business purpose other than obtaining tax benefits.

Like the subjective prong of the economic substance analysis, the phrasing of the objective test has varied among the different courts. For example, the Tax Court in ACM articulated the objective prong as requiring that there be "a reasonable expectation that the non-tax benefits would be at least commensurate with the transaction costs." 73 T.C.M. at 2217. The Third Circuit, on appeal of the same case, repeatedly searched for "any practical economic effects" of a transaction, other than the creation of income tax benefits by examining the taxpayer's financial condition before and after the transaction. ACM, 157 F.3d at 248-52. Under the Fourth Circuit's expression of the objective prong in Rice's Toyota World, a transaction has no economic substance where "no reasonable possibility of profit exists." 752 F.2d at 91. See also Friendship Diaries v. Commissioner, 90 T.C. 1054, 1062 (1988) (transaction could not have resulted in "economic profit"). Cf. Killingsworth v. Commissioner, 864 F.2d 1214, 1218 (5th Cir. 1989) (objective analysis involved examination of the "profit making potential"). While the specific articulation of the objective prong has differed among the courts, the fundamental principle is that a transaction must have real and practical economic effects other than the creation of income tax benefits to satisfy the objective aspects of the sham analysis. See Sochin v. Commissioner, 843 F.2d 351, 354 (9th Cir. 1988). Central to this notion is that where the profit derived from the transaction is "infinitesimally nominal and vastly insignificant when considered in comparison with the claimed [tax benefit]," the existence of a profit does not automatically preclude a finding that the transaction failed the objective prong of the economic substance analysis. See Sheldon v. Commissioner, 94 T.C. 738, 768 (1990); Chernin v. Commissioner, 89 T.C. 986, 993 (1987).

To the extent that only certain steps of the Transaction are disregarded or recharacterized under the economic substance doctrine, the substance of the remaining steps of the transaction should be analyzed before applying the applicable statutory provisions to determine the tax consequences associated with the remaining steps. See, e.g., American Electric Power v. United States, 136 F. Supp. 2d 762 (S.D. Ohio 2001); In re CM Holdings, 254 B.R. 578, 2000-2 U.S. Tax Cas. (CCH) P50,791 (D. Del. 2000).

Finally, to the extent a transaction is devoid of "nontax substance," courts have refused to recognize the tax consequences of the transactions (including promoter fees and related expenses) because they do not appreciably affect the taxpayer's beneficial interest except to reduce his tax. Knetsch v. United States, 364 U.S. 361, 366 (1960). Accordingly, to the extent that the transaction is a sham

in substance, in whole or in part, any tax benefits, fees or expenses, related thereto, may be disallowed.

2. Analysis.

Additional facts should be developed before applying the objective and subjective tests of the economic substance doctrine, discussed above, to the transaction. However, based on the available facts, it appears that the Transaction failed the objective prong of the economic substance doctrine. In the present situation, TP had an unrelated capital gain of approximately $a. On Date 2, Preparer sent TP (through PRS) a letter describing the steps TP should take to acquire a "highly leveraged position in the shares of [FB]" utilizing Promoter as the investment advisor. Through participation in this Program, TP was able to sell its FB option to acquire v bearer shares of FB stock as well as its t bearer shares of FB stock for a purported substantial tax loss of approximately $uu. The close relationship between the original tax gain of $a and the total purported losses (both claimed and built-in) suggest that TP did not enter into this transaction for a business purpose. As the 10th Circuit has recognized, "correlation of losses to tax needs coupled with a general indifference to, or absence of, economic profits may reflect a lack of economic substance." Keeler v. Commissioner, 243 F.3d 1212, 1218 (10th Cir. 2001) citing Freytag v. Commissioner, 89 T.C. 849, 877-78 (1987).

Generally, the transaction, in whole or in part, appears to fail the subjective economic substance prong because there does not seem to have been any useful non-tax purpose for entering into the transaction or certain steps thereto (e.g., TP's acquisition of FC warrants, FC's leveraged acquisition of FB stock with an equity collar, and TP's acquisition of out-of-the-money options to purchase FB stock and contribution of those options to PRS). Similarly, the transaction appears to fail the objective economic substance prong because TP's profit potential with respect to the transaction, in whole or in part, is insignificant compared to the anticipated losses claimed by TP in connection with the transaction or certain steps thereto (e.g., PRS's acquisition of FC warrants, FC's leveraged acquisition of FB stock with an equity collar, and TP's acquisition of out-of-the-money options to purchase FB stock and contribution of those options to PRS). Moreover, there does not seem to have been any practical economic effects of the transaction, in whole or in part, other than the creation of a tax loss for TP. Thus, based on the facts developed to date, the transaction may be viewed as a sham in substance, in whole or in part, and, to the extent the transaction is a sham in substance, any tax benefits, fees or expenses, related thereto, may be disallowed.

B. Applying the sham entity doctrine to disregard the existence of FC as an entity separate from its owner.

1. Law.

Another application of the economic substance doctrine is the sham entity doctrine. The sham entity doctrine may apply to variations of the transaction that have been marketed to disregard FC and treat FP (or TP, to the extent that TP is treated as the owner of FC under the substance over form analysis, discussed above) as engaging in the activities purportedly carried on by FC.

The determination of whether an organization is an entity separate from its owners for federal income tax purposes is a matter of federal tax law and does not depend upon whether the organization is recognized as an entity under local law. Section 301.7701-1(a)(1) of the Procedure and Administration Regulations. A corporate entity formed under local law is recognized as an entity for federal income tax purposes if its purpose is the equivalent of business activity or the corporation conducts business activities. See Moline Properties v. Commissioner, 319 U.S. 436, 438-39 (1943). Courts have understood the reference to the term "business activity" in Moline to exclude an activity whose sole purpose is tax avoidance. See ASA Investerings Partnership v. Commissioner, 201 F.3d 505, 512 (D.C. Cir. 2000).

2. Analysis.

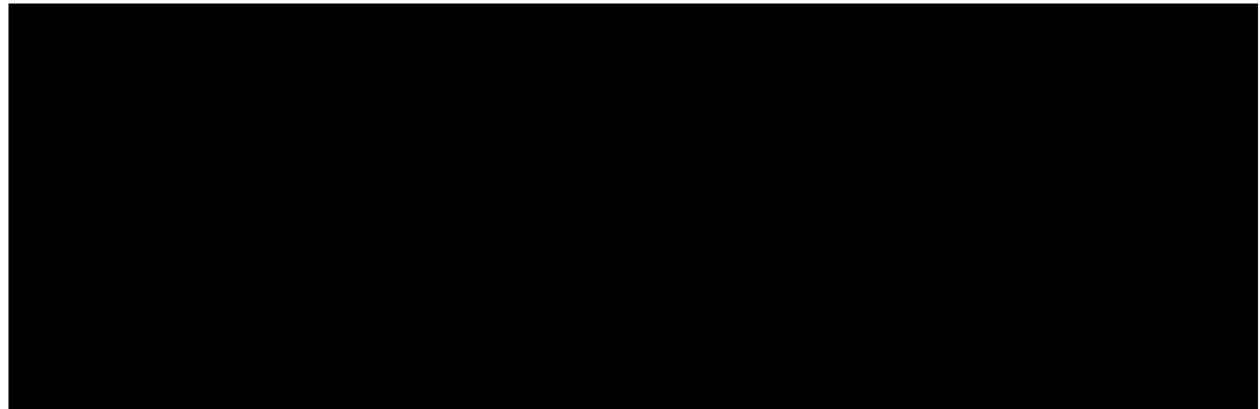
The facts demonstrate that FC and FP were formed for the sole purpose of engaging in the transaction and that the only day-to-day activities of FC and FP were likely to have been limited to those that related to the transaction. For example, the Engagement Letter suggests that the intended purpose of the $o that PRS paid under the warrant agreement would be used to pay fees and other expenses to FB, Promoter, legal counsel and Preparer in consideration for services rendered in structuring, facilitating, and executing the Program and that TP and PRS would be personally liable if such fees and expenses exceeded the warrant price. Other than helping TP generate a tax loss, which is a benefit personal to TP, we have been unable to identify any useful non-tax purpose for forming FC or for FC's participation in the leveraged acquisition of FB stock and/or the Transaction. Moreover, contrary to the normal case of a shareholder relationship with a corporation, FP had no real claim on FC's equity if FP could not participate in the appreciation to FC's assets. Therefore, we have not identified any useful non-tax purpose for forming FC and/or FP or for FC's participation in the leveraged acquisition of FB stock and/or the redemption of such stock, the sham entity doctrine may apply to disregard the existence of FC and/or FP as an entity separate

from its owner.[13] See ASA Investerings Partnership v. Commissioner, T.C. Memo. 1998-305.

If FC is disregarded as an entity separate from its owner, the tax consequences of the remaining steps of the transaction will depend upon whether TP, instead of FP, is the owner of FC under the substance over form analysis discussed in Issue 5. If FP is the owner of the FC stock, then the attribution rules of section 318 would not apply to treat the FB stock and options owned by PRS as owned by FP. Thus, the tax consequences would be as follows: (i) the redemption would be characterized as a sale or exchange under section 302(b)(3) to which FP would recover its basis; (ii) the basis shifting rule under Treas. Reg. § 1.302-2(c) could not apply; and (iii) depending upon the fair market value of the FB stock and out-of-the-money options on the date TP subsequently disposes of such stock and options, TP could recognize gain. Again, TP would neither realize nor recognize the claimed loss on the transaction.

Alternatively, if TP is the owner of the stock of FC, then TP (not FC or FP) entered into the highly leveraged acquisition transaction with FB to acquire the FB stock and PRS's FB stock was redeemed by FB. Under the analysis described above, the tax consequences of the redemption and sale of PRS's FB stock and options may be viewed as a sale or exchange under section 302(b)(3) to which gain or loss applies. Again, TP would neither realize nor recognize the claimed loss on the transaction.

Case Development, Hazards and Other Considerations



[13] Also, we believe that FC may have been formed as a conduit for the payment of fees to Promoter and accommodating parties to the transaction whose sole design appears to have been to allow TP to avoid federal income tax. For example, all of the fees associated with the transaction appear to have been paid from the amounts paid by TP to acquire the FC warrants.

Please call this office if you have any further questions.

Associate Chief Counsel (Corporate)
By: LEWIS K BRICKATES
Senior Technician Reviewer, Branch 4